IFRS 17 DEA – COVID 19 considerations
Issues Paper

Objective

1 The objective of this session is for the EFRAG TEG to consider the concerns around Covid-19 to be included in the IFRS 17 draft endorsement advice as well as the related questions to constituents.

Background

2 The EFRAG Board instructed EFRAG Secretariat to include a question to constituents on the topic of Covid-19 in Appendix III of the DEA, accompanied by qualitative observations about the possible direction of the impacts.

3 This paper was discussed by EFRAG IAWG on 25 June 2020. A verbal update of the discussion will be provided at the TEG meeting.

Stress testing in the full case study - 2018

4 During the case study, participants were asked to apply the EIOPA 2016 'Double hit' stress test exercise to both the IFRS 4 and 17 results for the selected portfolios. This was a stress of financial factors (stock market crash and sustained low interest rates) and did not include a technical stress such as the pandemic.

5 Only one respondent completed the stress testing questions for both current GAAP under IFRS 4 as well as IFRS 17 with six respondents answering for IFRS 17 but not for current GAAP. Furthermore, not all portfolios evaluated in other parts of the case study were considered in this section, resulting in a smaller sample than for the rest of the case study.

6 Under the stress impacts reported, the initial negative impact on the profit before tax varied between 0% impact on a unit-linked portfolio accounted for under the VFA and 400% impact on a combination of individual and bulk purchased annuities under the General Model. Most of the impacts resulted in a negative impact on the result between 20% and 30% for portfolios under the VFA. For general insurance, the impacts reflect the changes in asset prices and reflected a similar range to those under the VFA and under current GAAP.

Inputs received from the LUCS - 2020

7 One participant to the LUCS, expressed concern about the amortization of the CSM in cases of sudden decreases in fair value of the assets. The participant considered that there is a risk of a double effect on CSM due to the change in the fair value of the underlying assets, and the change in the Time Value of Options and Guarantees (TVOG). As an illustration, the participant referred to 18 March 2020 (the day when the French CAC 40 dropped by 5.94% and extreme equity volatility was observed).

Proposed wording in the DEA: Implications of Covid-19

NOTE TO CONSTITUENTS

8 The Covid-19 crisis is impacting all the sectors of the world economy and society, including the insurance sector, with unprecedent and unpredictable implications.

9 The analyses conducted in preparation of this DEA do not include an in-depth analysis of the possible effects of Covid-19 crisis on the expected impacts of IFRS 17, as such an in-depth analysis would not be compatible with the timing of this endorsement advice (also considering the feasibility of a detailed stress test exercise) and its reliability would be strongly impaired by the high degree of uncertainty that still exists on how the crisis will have finally impacted the European economy and the insurance sector at the effective date (January 2023).

10 Nevertheless, EFRAG invites its constituents to report their feedback on whether and to what extent:

(a) the Covid-19 crisis may accentuate the expected impacts of IFRS 17 on the insurance market and, indirectly, on the European economy as a whole. In doing so, constituents may refer to the description of the main impacts of the standard described below.

(b) they envisage reductions in the ambitions and objectives for the project, plans, multi-year budget or one-off investment spending and/or ongoing costs for the implementation of IFRS 17?

Macro-economic situation

11 The Covid-19 pandemic and the response to it in the context of the aftermath of the previous financial crisis has led to an unprecedented situation that has far reaching impacts on everyday life and business activities.

12 EFRAG notes that in its quarterly risk dashboard for Q1 2020[1], EIOPA has highlighted increases across substantially all the risks it monitors.

Risks	Level	Trend
1. Macro risks	Very High	↑
2. Credit risks	High	↑
3. Market risks	Very high	↑
4. Liquidity and funding risks	High	↗
5. Profitability and solvency	High	↗
6. Interlinkages and imbalances	Medium	→
7. Insurance (underwriting) risks	High	↗
8. Market perceptions	Medium	↗

EIOPA Risk Dashboard April 2020 (Q4 – 2019 Solvency II Data)

13 For example, macro and market risk indicators deteriorated in March 2020 given the decreases in forecast GDP, increases in unemployment as well as volatility in bond and equity markets. The results were increases in risk premia, flight to quality behaviour by investors with credit risk has increased across all asset classes. Liquidity and funding risks as well as profitability and solvency risks for insurers along with insurance risk have been raised to a high level.

14 The current situation may have similarities to the scenarios of the EIOPA stress tests in recent years which has enhanced and strengthened the supervisory

[1] Please refer to Appendix 1 for the executive summary and here for the full Risk Dashboard.

frameworks and the response of the industry to stress scenarios. The DEA also considers the interaction between IFRS 17 and IFRS 9 as well as the impacts on financial stability elsewhere in this appendix.

15 However, the specificities of the situation merit to be considered against the backdrop of significant uncertainty as to the duration and extent of the crisis and its ongoing impacts.

Impacts of the new standard

16 It is expected that IFRS 17 will increase transparency for the accounting for financial instruments for the following reasons:

(a) It will standardise and streamline the different accounting across Europe for IFRS preparers and introduce current value fulfilment measurement on a consistent basis for insurance liabilities;

(b) It will increase visibility of risk exposure of insurers, due to the adoption of the current value measurement of the liabilities, as profit or loss and balance sheet will be more volatile reflecting the changes in financial and non-financial variables in the reporting period;

(c) It has significant additional disclosures, both qualitative and quantitative, that aims to improve the understanding of users of such liabilities; and

(d) The hope is that the standardisation within the industry and compared to the rest of IFRS will also make it easier for non-specialist users to understand and analyse insurers.

17 An increase in transparency under IFRS 17, would be positive for public good in the context of improving visibility of deteriorating risks and conditions and this would be beneficial to the efficient allocation of capital in Europe.

18 In times of high economic volatility however, the increase volatility seen in the profit or loss compared to the situation under current insurance accounting practices may require significant explanation to internal and external stakeholders. Preparers are concerned that users will regard such volatility in a negative light and penalise their share price. However, views on this is mixed as users have indicated (refer to user outreach elsewhere in this appendix) that where the accounting reflects economic volatility this is not regarded negatively.

19 There is also a concern that IFRS 17 in the context of the pandemic and lower or more volatile results may create or increase behavioural incentives. For example, to modify contracts such as offering a lower level of guarantees for contracts and this may reduce savings options for purchasers. Another example would be to accept higher risk in return for higher asset returns in an effort to improve asset returns. The latter could increase the risk profile for entities that are systemically important to the financial health of Europe.

20 As also illustrated in the section Procyclicality of Appendix III, moving from IFRS 4 to IFRS 17 may have mixed implications in terms of procyclicality, while a key transmission mechanism of adverse effect (the distribution of dividends and/or bonuses for staff) would remain limited or prohibited as there is no direct link between book value of equity and the distribution capacity due to the Solvency II regulatory framework.

(a) In terms of idiosyncratic movement of performance and financial market:

(i) From one side the accounting value of equity and profit or loss tend to deteriorate in a downturn, reflecting lower interest rates and market returns and reduction in volumes of new business. An indirect impact may also be the increase in cost of capital (with consequential narrower access to financial capital) due to the highest perception of risk by the investors; however the expected increase in transparency would make the sector more understandable and support the confidence of the investors with positive impacts on the cost of capital.

(ii) From the other side, the deferral of revenues from premia granted in better times would ensure the existence of revenues also in downturn periods, with positive impacts on profitability.

(b) In terms of behaviour incentives that may exacerbate the magnitude of financial or real economic cycles, during a downturn:

(i) the lower returns will result in lower variable payments for saving products, deteriorating the financial prospects of policyholders. This impact however is not peculiar to IFRS 17 and was already in existence with IFRS 4 as it pertains to the contractual features of the products.

(ii) facing a higher risk profile due to the general deterioration in asset quality (including of assets that back insurance liabilities and guarantees), the entities may reduce their exposures to the highest risk assets, with resulting trading losses and possible consequences on higher market liquidity premia required for these assets.

Accounting impacts

21 As the accounting treatment for insurance contracts currently are not the same, it is difficult to compare impact of the crisis on the results under IFRS 4 and IAS 39 versus that of IFRS 17 and IFRS 9 on an overall basis and would require a detailed quantitative assessment.

22 The relative benefits would vary depending on current measurement under IFRS 4. For those products or countries where current measurement is already applied, the benefits of IFRS 17 may be limited compared to those not using current measurement principles. Similarly, where a current GAAP under IFRS 4 has significantly useful disclosures for users, the increased benefit of disclosures under IFRS 17 may be limited.

23 In "A potential macropudential approach to the low interest rate environment in the Solvency II context" (available here) EIOPA highlights two aspects related to procyclicality as follows: "A first definition of procyclicality refers to the short term tendency to invest in a way that exacerbates market movements and contributes to asset price volatility, which can in turn contribute to asset price feedback loops. But there is also a second definition of procyclicality that refers to a medium term tendency to invest in line with asset prices and economic cycles, so that willingness to bear risk diminishes in periods of stress and increases in upturns."

24 EIOPA also identifies that the impact of a low yield environment has the potential impact on the balance sheet where herd behaviour would replace higher-risk by lower-risk asset classes in a double-hit scenario and increase the technical provisions (as interest rates may decrease).

25 EFRAG notes that IFRS 9 was designed to improve concerns that were raised by the Great Financial Crisis of 2008. Furthermore, apart from Solvency II, some GAAPs used under IFRS 4 already incorporates current measurement and this has not raised procyclicality concerns either in the prudential regime or from a standard-setting perspective.

Investment and resources available for IFRS 17 implementation plans

26 The Covid-19 crisis may have an impact on the size of budgets available for transformational projects, with possible reductions in consultancy costs, new hiring of required skills, and investment in IT. This may result in a downsizing of the ambitions, such as moving from a transformational plan to a reduced compliance

exercise, with implications on the robustness of the process and IT solutions adopted.

27 Covid-19 has had a significant impact in how entities do business and how staff work together with lockdowns and social distancing changing the corporate landscape. Obviously, this has meant significant changes to how people and teams work together and may have increased the workload given the consequences of the crisis.

28 Furthermore, during a complex exercise such as the implementation of IFRS 17 and IFRS 9 these changes may have specific implications on resources – both internal and external as well as co-operation between various experts such as actuaries, accountants, and IT specialists.

Conclusion

29 Covid-19 crisis may have a negative impact on the size of the budgets dedicated to IFRS 17 transition and has had significant impacts in how entities do business and how staff work together. EFRAG notes that companies have adapted seemingly well to the new situation that has been in place for more than three months now and is unaware of any specific concerns relating to the transition to IFRS 17 and Covid-19.

Proposed questions to Constituents

30 Do the circumstances around the Covid-19 pandemic impact your implementation process for IFRS 17 and IFRS 9? Please explain in detail the impacts such as n project ambitions, budget for implementation investments and ongoing costs, resources, speed of implementation. Please also explain whether this relates to the IT systems implementation, or rather the actuarial or accounting aspects of implementation.

31 Are there other aspects around the implications of Covid-19, not yet addressed in the DEA that you want to expand on?

Questions for EFRAG TEG

32 Does EFRAG TEG have comments on the proposed drafting in the DEA? Please explain.

33 Are there other questions to constituents that need to be included? Please explain.

Appendix 1: Summary of risks facing the insurance industry

This appendix includes the executive summary of the risks facing the insurance industry per the EIOPA Risk Dashboard for April 2020.

EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

EIOPA REGULAR USE

EIOPA-BoS/20-274
18 May 2020

RISK DASHBOARD

April 2020[1]

Risks	Level	Trend
1. Macro risks	Very High	↑
2. Credit risks	High	↑
3. Market risks	Very high	↑
4. Liquidity and funding risks	High	↗
5. Profitability and solvency	High	↗
6. Interlinkages and imbalances	Medium	→
7. Insurance (underwriting) risks	High	↗
8. Market perceptions	Medium	↗

Note: Despite the fact that some indicators used in this Risk Dashboard do not capture the latest market development in the context of Covid-19 outbreak, the expected deterioration of the relevant indicators reflecting all available information in a forward looking perspective has been considered in the assigned risk levels. This addresses the current situation of high uncertainty in the insurance market.

Key observations:

- Risk exposures for the European insurance sector increased as the outbreak of Covid-19 strongly affected the lives of all European citizens with disruptions in all financial sectors and economic activities. Market developments point to a "double-hit" scenario negatively affecting insurers on both asset and liability side as tested in previous stress test exercises.
- Macro and market risks indicators deteriorated in March 2020, moving from high to very high level. Overall, GDP forecasts have been revised significantly downwards across countries for 2020. For the first quarter of 2020, EU estimates point to the sharpest decrease of GDP and employment in the last two decades. Inflation forecasts are pointing to downward revisions for the next four quarters. Monetary policy support has been activated by all major central banks. Financial markets have been characterized by sell-off across asset classes, increased volatilities for bond and equity markets, increasing risk premia and flight to quality investment behavior.

[1] Reference date for company data is Q4-2019 for quarterly indicators and 2019-YE for annual indicators. The cut-off date for most market indicators is end of March 2020.

- Credit risk has increased across all asset classes, in particular CDS of government bonds, financial and non-financial corporate bonds have increased sharply.
- Liquidity and funding risks raised to high level, as some indicators are expected to worsen via the latest market developments and the strong hit on economic activities, which is reducing incomes and could result in decreasing premiums and lowering new business. Moreover, the potential increase in claims and illiquid level of certain assets could put additional strains on the disposable liquidity of insurers in the medium to long-term horizon.
- Profitability and solvency risks increased to high level. A deterioration of indicators is estimated as a consequence of the recent negative market developments in the context of Covid-19 outbreak. Furthermore, a decrease in excess of assets over liabilities is expected, driven by drops in asset values and increase in liabilities. On the other hand, an improvement of the SCR ratios for groups and life undertakings across the whole distribution was observed in Q4-2019.
- Interlinkages and imbalances risks remain stable with an observed fall in the upper quartile of the derivative holdings distribution, potentially due to a market value reduction.
- Insurance risks raised to high level. The negative market developments may have negative effects via income reduction (due to the impact of drop in economic activity on new as well as existing business) and potential increase in claims for specific business lines.
- Market perceptions of the insurance sector has deteriorated as well. The EU insurance sector underperformed the market, both life and non-life businesses lines, and the median price-to-earnings ratio of insurance groups in the sample decreased since the last assessment. Insurers' CDS spreads increased, while insurers' external ratings and rating outlooks do not show sign of deterioration as of end March 2020.